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No. 88-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

JAN J. SAGETT *
PETER B. KELSEY
WILLIAM L. FANG
EDISON ELECTRIC INSTITUTE
1111 19th Street, N.W.
Washington, D.C. 20036
(202) 778-6616
Attorneys for
Edison Electric Institute

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* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

Whether a public utility rate order takes property without just compensation in violation of the Fifth and Fourteenth Amendments to the United States Constitution when it gives to ratepayers the benefit of a tax deduction arising from costs that were not paid by the ratepayers.

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BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

Edison Electric Institute ("EEI") submits its brief *amicus curiae* in support of the jurisdictional statement filed by Houston Lighting & Power Company ("HL&P"). Both parties to this appeal have consented to the filing of this brief by EEI.

INTEREST OF THE *AMICUS CURIAE*

EEI is the national association of investor-owned electric utility companies in the United States. Its members supply electric service to consumers throughout the country, serving approximately 97 percent of all customers of the investor-owned segment of the industry and approximately 75 percent of the nation's electric customers.

This case, which involves a decision by the Texas Supreme Court to allocate to ratepayers the tax benefits

relating to costs borne by the utility's shareholders, is of crucial importance to the utilities represented by EEI. With increasing frequency, state utility commissions have been disallowing recovery through rates of part or all of the significant capital costs of utility plant construction. Such disallowances can occur not only when a plant is cancelled, as in the case of HL&P's Allen's Creek Nuclear Project ("Allen's Creek"), but also with respect to a plant that achieves operation, if the state commission decides that some of the costs were imprudently spent.

When such costs are disallowed, commissions often prohibit utilities not only from earning a return *on* their investments, but also from recovering a return *of* the large sums of money invested. In those cases, the only benefits left to investors apart from the relatively small salvage value, if any, are the tax deductions allowable to the company on the loss of its investment. In a case such as this one, where the utility's investment has virtually no salvage value, allocation to the ratepayers of the tax benefits associated with the disallowed costs amounts to a complete confiscation by the state of the utility's property without compensation, in violation of the Fifth and Fourteenth Amendments.

Because of the widespread occurrence of state rate proceedings disallowing costs incurred by utilities to build new plants and the unique position of EEI as the national representative of investor-owned utilities that could be affected by this Court's decision, EEI offers this brief to assist the Court in its understanding of the reasons why probable jurisdiction should be noted. EEI fully endorses all of the arguments presented in HL&P's Jurisdictional Statement. This brief focuses on the fact that the decision of the Texas Public Utility Commission, affirmed by the Texas Supreme Court, resulted in a taking of HL&P's property without compensation in violation of the Fifth and Fourteenth Amendments to the U.S. Constitution.

SUMMARY OF ARGUMENT

This case presents constitutional issues of national importance. In recent years, various factors beyond their control have forced utilities to cancel numerous projects under construction. At the same time, state utility commissions have been increasingly unwilling to allocate to ratepayers all the costs associated with those projects. The large number of cases involving disallowed costs has raised a series of constitutional questions concerning the proper allocation of those costs between ratepayers and shareholders. This Court recently agreed to decide whether a decision of a state supreme court afforded a utility just compensation under the Fifth and Fourteenth Amendments for the dedication of its property to public service. The instant case presents the equally fundamental and important issue of whether the state regulators can use the ratemaking process to take nonutility property without just compensation.

Public utilities have a duty to dedicate their property to provide adequate service to the public. In return, the Constitution guarantees the utilities just compensation for the public use of their property through reasonable rates. When the Texas Public Utility Commission disallowed part of HL&P's investment in the Allen's Creek project, it ruled that the property represented by that investment was nonutility property, not dedicated to public service and not subject to recovery through rates. By allocating to ratepayers the tax benefits associated with the disallowed costs, the state commission took property the commission itself had treated as nonutility property and awarded it to ratepayers in further reduction of their rates. Under settled Fifth Amendment principles established by this Court, the state's action resulted in a confiscation of HL&P's property without just compensation, in violation of the Fifth and Fourteenth Amendments.

The state's action amounted to an unconstitutional taking under all three of the factors this Court traditionally examines: The character of the state's action was extraordinary, both in its reach and unfairness; the economic impact of the state's action on HL&P and, potentially, on the industry, is enormous; and the state's action interfered substantially with the legitimate, investment-backed expectations of HL&P's shareholders. *See, e.g., Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984). Where, as here, the state action is not undertaken to protect the public welfare, the taking violates the Fifth Amendment. *See, e.g., Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 125 (1978).

THE QUESTIONS PRESENTED ARE SUBSTANTIAL

I. THIS CASE PRESENTS AN ISSUE OF NATIONAL IMPORTANCE.

During the late 1960's, substantial annual growth in the demand for electric power and massive black-outs in the Northeast contributed to a nationwide concern about the dramatic need for increases in utilities' electric power generating capacity. In response, plans abounded for the construction of large, baseload nuclear generating facilities encouraged by federal policy established in the Atomic Energy Act, as well as facilities using other sources of energy. The economic recession of the mid-1970's, however, accompanied by several mild seasons and energy price inflation caused by the OPEC oil embargo, resulted in substantial decreases in the projected demand for additional generating capacity.

Enactment of the Public Utility Regulatory Policies Act and the Power Plant and Industrial Fuel Use Act in 1978, which were a legislative response to the perceived need to diversify fuel use and to encourage alternative sources of electric supply, further changed the regulatory landscape. At the same time, inflation and increasing regulatory requirements resulted in skyrocketing

construction costs and prompted many utilities to reconsider their plans to expand facilities.

The economic pressure to cancel new projects under construction has had widespread effects throughout the electric utility industry. Between 1977 and 1986 alone, at least 94 cancellation cases involving generating facilities of different types were heard in 34 jurisdictions. EEI Rate Regulation Department, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* 5 (1986) (hereinafter cited as "EEI Survey"). Nuclear power projects like Allen's Creek have encountered particularly crippling problems. Massive changes in regulatory requirements mandated by the Nuclear Regulatory Commission and resulting delays in completion of nuclear plants during a period of rapid inflation and high cost of capital have greatly increased the costs of such plants. Since 1972, 117 nuclear plant orders have been cancelled, and all nuclear plants that were ordered after 1973 have been cancelled. *See* U.S. Dep't of Energy, *Energy Security: A Report to the President of the United States* 189 (March 1987) (hereinafter cited as "DOE Report").

In the current climate, state regulatory commissions have exhibited an inclination against allocating to ratepayers the costs associated with cancelled plants. In 15 of the 94 cases cited above, state regulators decided that the utilities involved would not be entitled to any recovery through rates of the costs invested. EEI Survey at 5. In 67 of those cases, the regulators awarded only partial recovery to the utilities. *Id.* In other cases, even where the new plants had entered service, state regulators frequently have disallowed part of the massive costs invested as imprudently spent.

State regulators' recent unwillingness to grant rate increases necessary to cover the utilities' construction costs has been especially marked where a plant was cancelled

before it ever entered service. As a result, utilities and their investors have been penalized where a *post hoc* review condemned as imprudent investment decisions that appeared sound at the time they were made and approved. On the other hand, when utility investment decisions have proven to be sound, regulators routinely have allocated most of the benefits to the ratepayers. *See* DOE Report at 155.

The plethora of cases involving disallowed costs has raised a series of constitutional questions concerning the proper allocation of those costs between ratepayers and shareholders. Utility managers understandably view the present regulatory environment as a no-win situation that reflects a breakdown in the historic regulatory compact that has existed among utilities, their consumers and investors, and state regulators. *See id.* It has been decades since this Court decided a utility rate case involving the constitutionality of an alleged confiscatory rate order. EEI and its member utilities believe that the balancing of investor and customer interests in ratemaking required by this Court's decisions in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), has been ignored in many recent rate decisions. While this Court's agreement to hear argument in *Duquesne Light Co. v. Barasch*, No. 87-1160, *prob. juris. noted*, 108 S. Ct. 1105 (1988), may help to set state regulators back on course, the instant case presents a quite different constitutional issue that raises equally fundamental and important questions about the future of the utility industry.

The important constitutional issue here is whether state regulators can use the ratemaking process to take nonutility property without just compensation. The confiscation of nonutility property approved by the Texas Supreme Court in this case goes far beyond the disputes over which costs may be included in rate base. The

Texas Supreme Court affirmed a decision of the Public Utility Commission to disallow $166 million of the costs of the cancelled Allen's Creek project as imprudently spent; the remainder of the costs were adjudged prudent and recoverable from ratepayers over time. The Commission then allocated to ratepayers *all* of the tax benefits derived from the abandonment of the project—including the estimated $111 million tax benefit attributable to the disallowed costs not paid by ratepayers. The Commission thus awarded to the ratepayers virtually all of the value left in the utility's investment in the plant, even though the ratepayers were not required to bear the cost of that investment.

In denying rate recovery for costs of a cancelled project, state regulators have ruled that the investment represented by those costs was not property dedicated to public service and therefore was not property for which ratepayers were required to pay. The effect of those rulings is that the property represented by the disallowed costs is an investment for which utility investors are solely responsible.

The Texas court went even further, however, and required HL&P's investors to forfeit the remaining value of that investment by allocating to ratepayers *all* of the tax benefits deriving from the investors' loss on the abandoned plant. There has been at least one other case in which state regulators have used this method of penalizing utilities for investments later deemed imprudent. *See In re Central Vermont Pub. Serv. Corp.*, 86 P.U.R.4th 114 (Vt. P.S.C. 1987). These rulings represent a new and totally unjustifiable method for state regulators to impose on utility investors all of the risks and none of the benefits of capital projects and do not bode well for the future.

Industry experts expect that the nation will continue to require substantial amounts of new generating capacity in the years to come. In addition to the normal

increases in demand, existing facilities will grow older, becoming less efficient and less reliable. While the average age of the typical U.S. generating facility was about 15 years in 1985, the average age will be 25 to 30 years in the year 2000. This approaches the typical 30- to 40-year life of most facilities. DOE Report at 148.

If the method used here and in Vermont achieves widespread use, its combination with the recent tendency to exclude investment costs from rate recovery ultimately will severely disadvantage the interests of utility customers as well as the utilities themselves. Rates may be artificially reduced for the short term. However, imposing on investors all project risk—even the risk that investors will forfeit tax benefits ordinarily allowed on an investment's loss—eventually will raise the cost of electricity by hindering utilities' ability to raise much-needed capital for the future at a reasonable cost. The net result of these regulatory policies ultimately will be to endanger the financial stability of the utility industry. *See id.* at 154. The policy issues raised by this case involving the financial health of electric utilities and their ability to accommodate future demand for increased generating capacity thus are of critical national importance.

II. THIS CASE PRESENTS AN IMPORTANT CONSTITUTIONAL ISSUE NOT PREVIOUSLY ADDRESSED BY THIS COURT.

A. This Case Involves a Taking of HL&P's Nonutility Property Not Governed by This Court's Decision in *Hope Natural Gas* and Its Progeny.

Public utilities have a duty to provide adequate service to the public. *United Fuel Gas Co. v. Pub. Serv. Comm'n*, 278 U.S. 322 (1929); *see, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 1446c, § 35(a) (Vernon 1980). Utilities must invest capital to maintain reasonable service and to expand and

upgrade service as necessary to fulfill that duty.[1] *See New York ex rel. New York & Queens Gas Co. v. McCall*, 245 U.S. 345 (1917). Thus, electric companies are required to dedicate their utility property to providing electric service to the public.

The Fifth Amendment guarantees just compensation for private property taken for public use. U.S. Const., amend. V., cl. 4.[2] This Court has held that a utility may not be required to use its property for the benefit of the public without receiving just compensation for the services that the dedicated property renders. *In re Permian Basin Area Rate Cases*, 390 U.S. at 770; *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 690 (1923). *Accord Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23, 31 (1926); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 272, 290 (1922) (Brandeis, J., concurring). Utilities receive compensation for the property they dedicate to public use in the form of just and reasonable rates set by state utility commissions.

The state's power to regulate utility rates is premised on the dedication of utility property to public use. *See Munn v. Illinois*, 94 U.S. 113 (1877). The state consequently has no ratemaking power over property belonging to a utility that is not so dedicated. *See Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920). In the

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[1] Indeed, recent experience shows that utilities may be penalized for not fulfilling that need. *See Boston Edison Co.*, Docket No. 85-266A (Mass. Dep't of Pub. Util. June 26, 1986) (utility that decided not to construct new generating facilities because recent rate orders showed a likelihood much of the investment would be disallowed was penalized for not preparing for future requirements).

[2] The Fifth Amendment's prohibition against governmental takings applies to state action through the Fourteenth Amendment. In addition, the Fourteenth Amendment prohibits state action depriving any person of property without due process of law. U.S. Const., amend. XIV, § 1. The due process issue involved in this case is discussed at length in the Jurisdictional Statement at 20-22.

process of reviewing utility expenditures for capital projects such as Allen's Creek, state regulators decide which costs relate to utility property that serves the public and which relate to nonutility property. Expenditures that relate to utility property are accounted for in state-established rates; expenditures for nonutility property are excluded from rate recovery. C. Phillips, *The Regulation of Public Utilities: Theory and Practice* 195-96 (1984). Excluded costs thus are treated for ratemaking purposes like expenditures for any other property owned by the utility that is not dedicated to public service. In the case at bar, the rate order disallowing certain of the Allen's Creek costs excluded those costs from rate recovery and resulted in treatment of the property to which those costs relate as nonutility property.

The standard of review set by *Hope Natural Gas* and the *Permian Basin Area Rate Cases* determines whether the compensation received by utilities for the value of utility property dedicated to the public is adequate. That standard does not apply here, where the state has appropriated the value of nonutility property and used it to reduce rates payable for the public use of utility property. Because this case involves a taking of nonutility property, rather than the reasonableness of the compensation for the use of utility property, *Hope* and its progeny do not apply, and the case is governed by traditional Fifth Amendment principles.

B. Under Standard Fifth Amendment Principles, the Decision of the Texas Supreme Court Effected a Taking of HL&P's Property Without Compensation.

This Court's recent Fifth Amendment decisions have established no set formula for determining when a compensable taking has occurred, but have engaged in an essentially "ad hoc, factual" inquiry. *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984); *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). That inquiry has examined three primary factors in determining whether

" 'justice and fairness' require that 'economic injuries caused by public action' " must be deemed a compensable taking. *Monsanto Co.*, 467 U.S. at 1005 (quoting *Kaiser Aetna*, 444 U.S. at 175). Those factors are: (i) the character of the governmental action, (ii) the economic impact of the regulation, and (iii) the regulation's interference with reasonable investment-backed expectations. *E.g.*, *Monsanto Co.*, 467 U.S. at 1005; *Kaiser Aetna*, 444 U.S. at 175. The state's confiscation of HL&P's nonutility property in this case is unconstitutional under all three of these factors.

The breadth and unfairness of the state's action in this case were unprecedented. Under the guise of a ratemaking proceeding, state regulators first excluded from rate recovery a large portion of the Allen's Creek costs that the utility reasonably could have expected would be recovered in rates. The regulators then appropriated for the ratepayers virtually all remaining value in the nonutility property that the regulators themselves had excluded from the scope of the proceeding. No police power or other legitimate justification was offered for the appropriation. The additional reduction of rates by the amount of the tax benefit was not a legitimate part of the state's calculation of reasonable rates; rates already had been reduced to take account of the costs with respect to the Allen's Creek project that had been disallowed. By awarding HL&P's nonutility property to ratepayers in further reduction of their rates, the state acted unfairly and far exceeded its authority to regulate utility rates. *See Brooks-Scanlon Co.; Munn.*

Moreover, the state's action violated the Fifth Amendment. A taking of private property without compensation can be justified where public health and safety requires it. *E.g.*, *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 125 (1978). Where, however, no such justification has been offered, the state may not, simply "by *ipse dixit* . . . transform private property into

public property without compensation." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 164 (1980). Where, as here, the state action is a "forced contribution" to the governmental purpose without justification, the state's action violates the Fifth Amendment. *Id.* at 163. *Accord Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211 (1986); *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

The economic impact of the decision below is substantial to HL&P and potentially enormous to the industry. The Texas Public Utility Commission itself placed at $111 million the value of the property attributable to the disallowed costs. HL&P calculates that the tax benefit it was required to forfeit with respect to those costs represented virtually the entire value realizable from the disallowed costs. *See* Jurisdictional Statement at 9.

If other states follow Texas' and Vermont's lead, the potential economic effect on the industry as a whole is immense. As discussed above, a large number of rate cases in recent years have involved disallowed costs, and the trend shows no signs of abating. *See supra* at 5-6. In the current climate, state regulators already are using ratemaking proceedings to reduce rates for utility property to what utilities view as a constitutionally impermissible level.[3] If those regulators also are permitted to use their ratemaking authority to take *non-utility* property without compensation in order to reduce rates further, utilities will have few constitutional protections remaining to them. As a result, investors rightly will demand higher returns on equity capital invested in utilities, and the public will face higher electric utility rates.

Finally, the appropriation of HL&P's tax benefits with respect to the Allen's Creek project represents the most

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[3] EEI hopes that this Court's decision in *Duquesne Light Co.* will restore the constitutional balancing procedure for ratemaking proceedings required by *Hope Natural Gas* and its progeny.

fundamental interference with legitimate, investment-backed expectations of utility shareholders. Investors in HL&P took the risk that the utility's capital projects might be cancelled and that, in the currently changing regulatory climate, investors might be denied full recovery of their investment, as well as a reasonable return thereon. However, investors in HL&P did *not* take the risk that the tax deductions ordinarily available to investors who suffer a loss would be appropriated by the state and awarded to ratepayers in further reduction of their rates.

The expectation defeated by the challenged regulatory action is far more than merely a " 'unilateral expectation or an abstract need.' " *Monsanto Co.*, 467 U.S. at 1005 (quoting *Webb's Fabulous Pharmacies*, 449 U.S. at 161). It is a right established by federal statute in section 165 of the Internal Revenue Code. *See generally Monsanto Co.* (property interest established by an independent source of law is protected by Fifth Amendment). The interference by Texas regulators with this eminently reasonable investment-backed expectation alone should be sufficient to constitute a compensable taking under this Court's decisions. *See id.* at 1005 (interference with reasonable investment-backed expectations so overwhelming as to enable Court to decide on that ground alone that a taking had occurred). *Accord Hodel v. Irving*, 107 S. Ct. 2076 (1987) (character of governmental action alone sufficient to enable court to hold there was a taking).

As discussed in the Jurisdictional Statement, the appropriation of all of HL&P's tax benefits rendered the Allen's Creek nonutility property essentially worthless since the property had little salvage value. *See* Jurisdictional Statement at 9. State action not undertaken on the grounds of protecting the public welfare that leaves private property with essentially no material value effects a taking for which compensation to the owner is due. *See, e.g., Irving*, 107 S. Ct. at 2084. Since it is the

" 'deprivation of the former owner rather than the accretion of a right or interest to the sovereign' " that constitutes a taking, *Monsanto Co.*, 467 U.S. at 1004-1005 (quoting *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945)), it is clear that the state's appropriation of virtually all the value remaining to investors in the nonutility property constitutes a compensable taking.

CONCLUSION

This case presents constitutional issues of national importance. Neither the Court's existing precedents in *Hope Natural Gas* and its progeny, nor *Duquesne Light Co.*, in which this Court has noted probable jurisdiction, can resolve the issues presented here. For these reasons, the Court should note probable jurisdiction and set this case for oral argument.

Respectfully submitted,

JAN J. SAGETT *
PETER B. KELSEY
WILLIAM L. FANG
EDISON ELECTRIC INSTITUTE
1111 19th Street, N.W.
Washington, D.C. 20036
(202) 778-6616
Attorneys for
Edison Electric Institute

August 1, 1988

* Counsel of Record